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IN THE

Supreme Court of the United States

October Term, 1942.

Nos. 11-19, 32

IN THE MATTER

of

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY,

Debtor.

GROUP OF INSTITUTIONAL INVESTORS and MUTUAL SAVINGS BANK GROUP,

Petitioners,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, *et al.*,

Respondents.

RECONSTRUCTION FINANCE CORPORATION,

Petitioner,

vs.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, *et al.*,

Respondents

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF ON BEHALF OF (1) FIFTY YEAR MORTGAGE TRUSTEES AND (2) PROTECTIVE COMMITTEE FOR FIFTY YEAR MORTGAGE BONDS, RESPONDENTS.

EDWIN S. S. SUNDERLAND
MALCOLM FOOSHEE
Attorneys for Fifty Year Mortgage Trustees

HENRY F. TENNEY
Of Counsel

C. FRANK REAVIS
Attorney for Protective Committee for Fifty Year Mortgage Bonds

MALCOLM MECARTNEY,
Of Counsel

October 6, 1942.

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ABBREVIATIONS SOMETIMES EMPLOYED IN THIS BRIEF

Abbreviations	*Full Title*
Fifty Year Mortgage Trustees	Guaranty Trust Company of New York an Arthur E. Burke
Fifty Year Mortgage	Mortgage and Deed of Trust of Chicago, Milwau kee and St. Paul Railway Company, dated as o February 2, 1925
5s of 75	Chicago, Milwaukee, St. Paul and Pacific Rail road Company Fifty Year 5% Mortgage, Gol Bonds, Series A, due February 1, 1975
Protective Committee	The Protective Committee for the Fifty Yea Bonds
Debtor	Chicago, Milwaukee, St. Paul and Pacific Rail road Company
Commission	Interstate Commerce Commission
Circuit Court	Circuit Court of Appeals for the Seventh Circui
District Court	District Court for the United States for the North ern District of Illinois, Eastern Division
Commission's Plan	Plan of Reorganization certified by the Commis sion to the District Court
Committee's Plan	Plan of Reorganization presented by Institutional Investor's Group
Debtor's Plan	Plan of Reorganization filed by Debtor with its Original Petition
Generals	Chicago, Milwaukee and St. Paul Railway Com pany, General Mortgage, 4% Gold Bonds, Series A-E, inclusive due May 1, 1989
Group or Institutional Group	Group of Institutional Investors
Groups	Groups of Institutional Investors and Mutual Savings Bank Group
Lines East	Debtor's lines east of the Missouri River
Lines West	Debtor's lines west of Mobridge, South Dakota
Pieces East	Various stretches of line east of Mobridge, South Dakota
R. F. C.	Reconstruction Finance Corporation
The Terre Haute	Chicago, Terre Haute and Southeastern Railway Company
The Gary	Chicago, Milwaukee and Gary Railway Company
The Milwaukee & Northern	Milwaukee & Northern Railroad Company

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BRIEF ON BEHALF OF (1) FIFTY YEAR MORTGAGE TRUSTEES AND (2) PROTECTIVE COMMITTEE FOR FIFTY YEAR MORTGAGE BONDS, RESPONDENTS.

This brief is submitted on behalf of (1) Guaranty Trust Company of New York and Arthur E. Burke* (herein sometimes called the "Fifty Year Mortgage Trustees") as trustees under the Mortgage and Deed of Trust of Chicago, Milwaukee, St. Paul and Pacific Railroad Company (herein sometimes called the "Debtor") dated as of February 2, 1925 (herein sometimes called the "Fifty Year Mortgage"), securing the Chicago, Milwaukee, St. Paul and Pacific Railroad Company Fifty Year Five Per Cent. Mortgage Gold Bonds, Series A, due February 1, 1975 (herein sometimes called the "5s of 75"); and (2) the Protective Committee for the Fifty Year Bonds (herein sometimes called the "Protective Committee"). (The Fifty Year Mortgage Trustees and the Protective Committee are herein sometimes collectively referred to in the first person plural.)

The Fifty Year Mortgage Trustees and their counsel have intervened and participated in the proceedings for the reorganization of the Debtor before the District Court of the United States for the Northern District of Illinois, Eastern Division (herein sometimes called the "District Court"), before the Interstate Commerce Commission (herein sometimes called the "Commission") and before the Circuit Court of Appeals for the Seventh Circuit (herein sometimes called the "Circuit Court"). The Protective Committee was authorized by the Commission to intervene on May 24, 1938 and it and its counsel have participated in all proceedings since that date.

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*Mr. Burke recently succeeded Merrel P. Callaway as individual Trustee.

REPORTS, ORDERS AND OPINIONS BELOW

The initial report (R. 2153-2269) and order (R. 1258-83) of the Commission decided February 12, 1940 are reported in 239 I. C. C. 485, and its supplemental report (R. 1284-1317) and supplemental order (R. 1319-47) decided June 4, 1940 are reported in 240 I. C. C. 257. The plan of reorganization certified by the Commission to the District Court is embodied in this supplemental order, and is herein sometimes called the "Commission's Plan". The opinion of the District Court dated October 21, 1940 (R. 1857-99) is reported in 36 F. Supp. 193; its findings of fact, conclusions of law, order and decree entered November 13, 1940 appear at R. 1978-92. The opinion of the Circuit Court dated December 4, 1941 (R. 2297-2317) is reported in 124 F. (2d) 754; its judgments entered the same day appear at R. 2318-24. Its memorandum opinion dated January 12, 1942. and order entered the same day, denying a motion to modify its original opinion, appear at R. 2334-5.

JURISDICTION

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. § 347(a)) and Section 24(c) of the Bankruptcy Act as amended (11 U. S. C. A. § 47(c)). The judgments of the Circuit Court were entered December 4, 1941 (R. 2318-24).

INTRODUCTORY STATEMENT

At the outset, we wish to make it clear beyond any possibility of misunderstanding that we do not attack the

Commission's Plan because of what the Group of Institutional Investors (herein sometimes called the "Group" or the "Institutional Group") and the Mutual Savings Bank Group (herein together sometimes called the "Groups") in their brief call "lack of formalism". We agree entirely with the following statement of general principles which is made by way of summary at page 101 of the Groups' brief dated September 21, 1942:

> "The requirement of findings is a realistic and practical one, intended to effectuate the administrative process and not to frustrate it by demands which cannot be met. This Court has never held that an administrative determination must have the formal niceties of a pleading at common law."

We likewise agree with the statement at pages 13-14 of the brief submitted to this Court on behalf of the Reconstruction Finance Corporation (hereinafter called the "R. F. C."):

> "Universal dollar valuations are unnecessary and impracticable, and would cloak with delusive exactness the elements of judgment involved. Thus, where dominant weight is given to earning capacity, stockholders may be excluded upon a determination that their equity is without value. Similarly, it is submitted, where contributions of different mortgage divisions to the earning power of the total enterprises are shown, the new securities may be distributed essentially on the basis of such contributions without attempting the intermediate formality of dollar valuations."

We cannot agree, however, in the first place, that the Circuit Court held the Commission's Plan deficient "not in substance but in form". (Groups' brief, p. 20.) We

think it clear that the Court's holding went to the substance. In the second place, we take emphatic exception to the repeated statements in the briefs of the Groups and the R. F. C. to the effect that there is in this case a sufficient foundation of essential facts for the formulation of a fair and equitable plan of reorganization, and particularly to the effect that an adequate inquiry was made into the cardinally important factor of earning power—more specifically into the relative earnings contribution of the 5s of 75. However, before showing the insufficiency of the basic record here and the scant consideration which the earning power of the 5s of 75 has received, it seems appropriate first to answer the petitioners' argument that the holding of the Circuit Court was one going solely to form and not to substance.

The petitioners' position in this respect is that the Circuit Court held that there must be sent back to the Commission "for further refinement in matters of form" (Groups' brief, p. 103) a plan of reorganization "which is held [by the Circuit Court] to be supported by the evidence" (Groups' brief, p. 21). An examination of the Circuit Court's opinion provides a complete answer. As the Circuit Court pointed out (R. 2315-6):

> "Our criticism is not directed to the fact that the findings were embodied in the Commission's report (a large part of which is devoted to a discussion and statement of the evidence) rather than stated specifically as findings. But the fault lies in the fact that we are left uncertain, or in the dark, as to the finding of the Commission. The evidence might support a finding of a larger or a smaller amount. Which should we accept? The fact finding body is the I. C. C. It must find. We cannot." (124 F. (2d) 754, 766.)

Under such circumstances the Circuit Court was compelled to hold that the District Court did not have a sufficient foundation of fact on which to base a proper judgment as to the fairness and equity of the Commission's Plan, and to remand the proceeding to the Commission.

While the Circuit Court indicated in some parts of its opinion that the case had to be remanded because of the absence of "findings", an examination of the whole opinion shows clearly that the Court meant thereby not the requirement that the Commission's conclusions be stated in some particular manner, but, rather, that whatever conclusions are reached shall be fully supported by the necessary foundation of evidence.* Thus, after having stated that

*We agree with the R. F. C. (Brief, p. 35) that additional light on the nature of the Circuit Court's decision in this case may be found in its decision, rendered shortly thereafter, in *In re Chicago and North Western Railway Company*, 126 F. (2d) 351 (C. C. A. 7th, 1942). There it affirmed decrees (of the same District Court which approved the plan in this proceeding) approving the plan of reorganization for the Chicago and North Western which had been certified by the Commission. The Commission's conclusions and findings were stated in the same general form as in this proceeding. There, however, the evidence and the fundamental foundation of facts in the record were more adequate, including, as shown below, earnings segregation studies and severance studies.

In approving the plan certified by the Commission for the Chicago and North Western, accordingly, this same Circuit Court pointed to the following two angles (among four) from which it had "approached, considered and disposed of the findings requirement":

> "The completeness of the evidence on the specific issue whereon findings could and should have been made.
>
> * * * * * * * * * *
>
> "The persuasive effect of facts shown by the record and reduced to findings by the I. C. C., which strongly support the plan submitted and approved by the District Court and the creditors" (126 F. (2d), at 368-369).

"the fairness of the allocations involves factual issues" (R. 2307) and having referred to the *Consolidated Rock Products* case* and the *Los Angeles Lumber* case,* the Court said (R. 2308):

> "We find nothing in either case which would defeat the plan here in question, provided *the evidence,* and necessary findings are made, *based on such evidence, and they establish the fairness of the plan.*" 124 F. (2d) 754, 762.**

Later, in discussing the 5s of 75 and the General Mortgage Bonds, the Court said that in view of the reversal and remanding of the case which it found necessary, it would "not discuss at great length, or in great detail, the fairness of the plan with respect to these two mortgages" (R. 2311-12). While it added the same observation made with respect to the treatment of the other issues discussed, viz. that "the fact situation permits" of a plan such as the Commission approved, the Court's opinion clearly shows that it did not mean to conclude that the evidence in the record supports the plan.† Thus, after discussing the objections made by the various other security issues, the Court said (R. 2314):

Consolidated Rock Products Co. v. DuBois, 312 U. S. 510 (1941); *Case* v. *Los Angeles Lumber Products Co.,* 308 U. S. 106 (1939).

**Italics ours throughout unless otherwise stated.

†Thus demonstrating that the Court's statement immediately following (R. 2312) to the effect that the 5s of 75 have no legitimate complaint is not intended to be taken as a settled conclusion or finding by it upon the question of allocation between classes of securities. It was impossible for the Court to reach conclusions without an adequate foundation of fact. The Court likewise commented generally upon the General Mortgage Bonds, even making a "suggestion" regarding their treatment (R. 2312-13).

> "It may be observed that in our opinion there is evidence in the record to support the plan as proposed, but it cannot receive final approval until and unless there are findings made upon such evidence, and then the parties interested may have the right to review both the sufficiency of the findings to support the plan *and the existence of evidence to support the findings.*" 124 F. (2d) 754, 765-766.

The Court elaborated its meaning on the next page (R. 2315) of its opinion by saying:

> "We appreciate that the findings of fact must, in the last analysis, be based upon evidence, *much of which* is to be found in the report of the Interstate Commerce Commission. Hence it may well be argued that the Interstate Commerce Commission *could* make such findings by taking notice of its reports and the statistical information *in its files* bearing upon the income of this railroad and of its various branches. * * *"
>
> "[The Commission] must make fact findings *supported by the evidence* upon which its plan is based. We must independently determine whether the plan is fair and equitable. In reaching our conclusion we must ascertain (a) *whether there is evidence sufficient to support the findings,* (b) we must be able to say that the findings support the plan, and (c) the plan is fair and equitable." 124 F. (2d) 754, 766.

After this repeated emphasis placed by the Circuit Court of Appeals on the necessity of evidence to support findings of the Commission, it is clear that, as that Court said, its "criticism is not directed to the fact that the findings were embodied in the Commission's report * * * rather than stated specifically as findings" (R. 2316). Its holding goes deeper. It goes to the lack of an underlying founda-

tion of evidence sufficient to provide a basis for a fair and equitable plan of reorganization. The lack of essential evidence to support the plan is a defect which cannot be cured by stating findings in some particular form.

We are in entire agreement with the statements of the Groups and the R. F. C. that the "fatal infirmity" of the plan in the *Consolidated Rock Products* case was "the absence of the vital evidence necessary to sustain it," (Groups' brief, p. 97) and that "the difficulty was not the form of the findings made but the lack of essential evidence to sustain the plan" (R. F. C. brief, p. 15). In this reorganization, too, there is an absence of the vital evidence necessary to sustain the plan.

The second principal point made by the Groups and by the R. F. C. to which we take exception is reflected in statements that the record was "full and complete" (R. F. C. brief, pp. 14; 105); that it included "comprehensive earnings studies" and "a searching examination and evaluation of the different railroad [mortgage] divisions" (Groups' brief, p. 100); that "all requisite valuation data and all other information necessary for the reorganization of the Debtor" were developed in the hearings (R. F. C. brief, p. 104); and that the Commission gave the matter "exhaustive consideration" (Groups' brief, p. 76).

As is more fully brought out below, we have repeatedly shown both before the Commission and the Courts that a basic record essential for the formulation of a fair and equitable plan of reorganization has never been made in this case. It is true that the briefs of the Groups and the R. F. C. are able to point to the lapse of over five years from the beginning of this proceeding in 1935 to the approval of the Commission's Plan by the District Court in

1940, and to refer to the sequence of hearings before the Commission. But the character and extent of those hearings must also be considered. In considering the hearings and the evidence presented, it is necessary to bear in mind not only the shortness of the effective time schedule but also the fact that until 1938, there was no plan before the Commission proposing a disturbance of the lien of the Fifty Year Mortgage.

Until 1938 the only plan before the Commission was a "stand-by" plan which was filed by the Debtor in 1935 with the support of the principal creditor parties. This plan constituted a sort of moratorium *under which the lien of the Fifty Year Mortgage was not to be disturbed.* During the two years following the filing of this plan the proceedings went along on this basis, with the introduction of no evidence other than that prepared by the Debtor for this "stand-by" plan. This evidence included no substantial study of relative earning power. When, in the fall of 1937, the presiding Commissioner closed the hearings against the desires of substantially all of the parties (R. 673), the Groups obtained a reopening only by promising to submit a plan within a very short time (R. 692). Being thus pressed for time, the Groups had to use whatever was at hand, regardless of its inadequacy. A bare two months was allowed by the Commission between the filing of the Groups' Plan in January 1938 and the final closing of these proceedings in March 1938.

Although the Groups' Plan—involving complete disruption of the lien of the Fifty Year Mortgage—was fundamentally different from the Debtor's stand-by Plan, all requests for additional time for the preparation of basic studies necessary and appropriate to any such plan were

denied. The "extensive" hearings and consideration referred to by the Commission, by the Groups, and by the R. F. C. accordingly reduce themselves in practical effect to the allowance of a period of two months early in the year 1938, during which two sets of hearings were held by the Commission, but which did not afford opportunity for the preparation of essential studies or additional appropriate data.

Broadly speaking, there is but one basic issue in these proceedings, namely, is the Commission's Plan fair and equitable and does it conform to the requirements of the law of the land pursuant to the provisions of Section 77 of the Bankruptcy Act as amended (11 U. S. C. A. § 205)?

We do not contend that the Commission's Plan fails to meet these requirements because the findings lack formalism or because of the amount to which it limits the total new capitalization of the reorganized company. Our contention goes to the inadequacy of the factual foundation in this case, and to the unfairness of allocating, within the total new capitalization fixed by the Commission, to the 5s of 75 for their present fixed interest debt secured by a first lien on an important part of the System and a second lien on substantially all the remainder, only 15% in new contingent-interest bonds of a subordinate series (Series B), 60% in preferred stock and 25% in common stock.

More specifically, the issue involves the dearth of data as to earning power and the inadequacy of the so-called "formula" for the segregation of earnings; the lack of any severance study or contributed traffic study; the disregarding of important elements of value on which the 5s of 75 have a lien, including their equity in the Terre Haute rail-

way and the other securities pledged under the First and Refunding Mortgage; the failure to give proper recognition to the other relevant factors in determining the value of the security supporting the 5s of 75; and the unfairness to the 5s of 75 because of the change of 85% of their debt securities into stock, with the resultant drastic diminution of their income because of the impact of taxes.

From a procedural standpoint, since we were appellants, we obtained the relief requested of the Circuit Court by us. But since an affirmance of the decision of the Circuit Court must be coupled with explicit directions to the courts and to the Commission,—not only in order to effectuate a fair and equitable plan in this case, but also to provide a basic guide for the many other pending railroad reorganizations —we did not oppose the petition of the Groups and the R. F. C. for a writ of certiorari.

As the Groups say in their brief in support of their petition for certiorari (p. 56):

> "The termination of this lengthy proceeding by a decision on the merits is a matter of great public importance * * *. Uncertainty and expensive litigation will continue until this Court shall define the effect to be given to the Commission's findings and reports. Such a definition to be fully effective must, we believe, be made as a holding in a decision on the merits."

As the Groups further urge in the conclusion (p. 104) of their brief, "The entire record is before this Court". We join with the Groups and the R. F. C. in requesting that the consummation of a reorganization herein be expedited by a decision by this Court on all the fundamental issues, so that a plan of reorganization may be carried into effect

as soon as possible,* and so that the parties, as well as the Commission and the Courts, may be fully apprised of the "practicable principles and procedure to be followed in railroad reorganizations on the matters here involved" (R. F. C. brief, p. 106).

STATEMENT OF FACTS

A. Description of and Security Supporting the 5s of 75

The 5s of 75 are now outstanding in the principal amount of $106,395,096. The total claim of the 5s of 75, as of September 30, 1942, is approximately $144,600,000, which includes interest at 5% from February 1, 1935, after giving effect to the payment of $2,576,154.79 interest pursuant to Order No. 956 of the District Court of April 14, 1942.

The 5s of 75 were created in the reorganization of 1925-1928, approximately $60,000,000 being issued at par to the old stockholders for cash and approximately $46,000,000 going to certain bondholders of the old Chicago, Milwaukee and St. Paul Railway Company, who took 20% of their claim in 5s of 75 and the rest in a junior security. Of the cash thus raised $52,000,000 was paid to the Government for loans made during the period of federal administration (R. 257, 265).

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*We concur with the Groups and the R. F. C. (see footnote, pages 104 and 106 of their respective briefs) that the holding of this Court in *Story Parchment Co.* v. *Paterson Co.*, 282 U. S. 555, 567 (1931) is applicable here:

"The entire record, however, is before this Court with power to review the action of the Court of Appeals and direct such disposition of the case as that Court might have made of it upon the appeal from the District Court."

The 5s of 75 are a direct obligation of the Debtor, secured by a lien immediately junior to that of the First and Refunding Mortgage. That mortgage was also created in the reorganization of 1925-1928, but no bonds were issued until 1934. None of these bonds are in the hands of the public. All of the $8,665,000 (I. C. C. Ex. 73) principal amount of First and Refunding Bonds now outstanding are pledged with Reconstruction Finance Corporation as partial security for short term loans totaling less than $10,500,000.* These R. F. C. loans are also secured by the pledge of $11,212,000 of the Debtor's General Mortgage Bonds, $301,000 Bellingham Bay and British Columbia Railroad First Mortgage Bonds, and assignment of the Debtor's advances to the Chicago Union Station amounting to $3,124,249 (Ct. Ex. 27, August 6, 1940).

In view of the entire adequacy (R. 963-8) of the security held by the R. F. C. for its loans, the Circuit Court has recognized (R. 2301) that as a practical matter the 5s of 75 are to be considered as having a first lien on all security now supporting the First and Refunding Mortgage, including the Lines West, and a second lien on the Lines East (*i.e.*, the lines east of the Missouri River on which the General Mortgage has a first lien). Accordingly, this brief refers to the Fifty-Year Mortgage as a *first lien* on the following:**

(a) A first lien on 3435.33 miles of road which for purposes of discussion have been separated into (I. C. C. Ex. 91);

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*The total of R. F. C. loans as reduced is now under $10,500,000; there having been a further reduction from the $10,780,762.50 owed at the time Mr. Severs testified (R. 1566).

**Which were listed in I. C. C. Exs. 73 and 91 as subject to the prior lien of the First and Refunding Mortgage.

(1) The lines west of Mobridge, South Dakota (herein sometimes called the "Lines West"—*i.e.* the lines west of the Missouri River), comprising 2860.39 miles; and

(2) Various stretches of line east of Mobridge (herein sometimes called the "Pieces East"), comprising 574.94 miles in all. The Debtor, in its Exhibits 73 and 91 introduced before the Commission in August of 1935, listed these Pieces East as subject to the lien of the Fifty Year Mortgage, and not as subject to the lien of the General Mortgage. Some two and a half years later, however, the trustee of the General Mortgage of Chicago, Milwaukee and St. Paul Railway Company dated May 1, 1889 (herein sometimes called the "General Mortgage") decided to claim a prior lien on this property under the after-acquired property clause of that mortgage (R. 1131). This claim, however, was never presented for decision to the Court, although the Commission ruled that the question is primarily a judicial one (R. 1151).

(b) A first lien on the leasehold interest of the Debtor in Chicago, Terre Haute and Southeastern Railway Company (herein sometimes called the "Terre Haute").

(c) A first lien on a large amount of stocks and bonds of railroad and terminal companies, the most important of which are the 15,198 shares of Indiana Harbor Belt Railroad Company capital stock, representing all but 2 shares of the Debtor's 20% interest in this road, and the $4,045,720 (about 97%) of the outstanding Terre Haute capital stock.

(d) A first lien both on valuable trackage rights and on various units of equipment, the depreciated book value of which is stated as of June 30, 1935 to be $4,513,181 (I. C. C. Ex. 73).

(e) A second lien on all of the properties covered by the General Mortgage, as well as by the Deed of Trust of Chicago, Milwaukee and Gary Railway Company (herein sometimes called the "Gary") dated April 1, 1908 and the Bellingham Bay and British Columbia Railroad Company First Mortgage.

(f) A lien on all of the properties of the Milwaukee & Northern Railroad Company (herein sometimes called the "Milwaukee & Northern") subject to the lien of its First Mortgage and of its Consolidated Mortgage.

In short, the 5s of 75 have, in practical effect, a first lien on the lines west of the Missouri River, and (see paragraph a (2) above) on the 575 miles of "Pieces East"; and a second lien on the bulk of the remainder of the system—that is, on all the properties subject to the General Mortgage, which it should be noted does not, in turn, have any lien on the Lines West. The only system property on which the 5s of 75 do not have a first or second lien is the relatively short Milwaukee & Northern, which is subject to the prior liens of its First Mortgage of $2,155,000 and of its Consolidated Mortgage of $5,092,000.

In exchange for their present fixed interest bonds, secured by the above first and second liens on the system property, the Commission's Plan proposes to give the 5s of 75 only 15% of their claim in what are in effect third-ranking system bonds—*i.e.*, a contingent interest bond of Series B which, although to be secured by a second mortgage on the system, is to have its interest subordinated to the Series A income bonds issued under the same mortgage, is to be entitled to no sinking fund until the Series A bonds have been retired, and is to mature (in 2039) 25

years after the Series A bonds mature. For the remaining 85% of their claim, the 5s of 75 are to receive stock, 60% in preferred and 25% in common.

The Debtor's fixed charges under its present capital structure are fully covered, including $5,320,000 a year interest on the 5s of 75, when system income available for interest amounts to approximately $14,500,000. Under the Commission's Plan, in order for the 5s of 75 to receive on the new securities the amount of their present interest (disregarding accrued and unpaid interest since 1935), it will be necessary for the reorganized company to be able to pay the full dividend on its preferred stock and about $5 on each share of common stock. However, as shown below, because of the tax burden occasioned by the conversion of debt into stock, it is estimated that the full dividend cannot be paid on the preferred stock of the reorganized company out of earnings as great as those for the calendar year 1941 (approximately $28,900,000 available for interest), and no dividend can be paid therefrom on its common stock.

B. Inception and Course of These Proceedings

On June 29, 1935 the Debtor filed its petition for reorganization under Section 77 of the Bankruptcy Act as amended (R. 2-5), to which its plan of reorganization (herein sometimes called the "Debtor's Plan") was annexed as Exhibit "A", and on the same day the petition was approved by the Court as properly filed. At that time the Debtor likewise filed its petition with the Commission and also its plan of reorganization.

This plan was prepared and presented with the idea that relatively minor sacrifices should be made by all parties involved; that a reorganization should be promptly effected,

so as to preserve the Debtor's financial and operating good will and yet avoid sudden rearrangement of the entire capital structure on the basis of depression earnings and exceptional uncertainties; and that existing priorities should be observed and *liens left undisturbed* except as to the Debtor's Adjustment Mortgage, which is junior to the Fifty-Year Mortgage securing the 5s of 75 (R. 260-2, 266-7, 270; 510). Reconstruction Finance Corporation agreed to make a ten year loan of $12,000,000 at 4%, secured by bonds to be issued under the Debtor's First and Refunding Mortgage, and to buy $12,000,000 of 4% equipment trust certificates, thus providing the new financing. This commitment was subject to certain conditions, most important of which was that reorganization should be completed by the end of 1935 (Letter of Chairman Jones to President Scandrett, June 3, 1935, R. 464-5).

The Hearing in August of 1935

Near the close of the first hearing before the Commission on August 7, 1935, counsel for the Institutional Group stated that it regarded the Debtor's Plan with favor, provided adoption and acceptance could be effected promptly. Briefly, this approval was said to rest on considerations which included the following: continuation of income to bondholders in the order of their priority; preservation of the efficiency and morale of the operating organization through early reorganization; and a minimum of procedural expense. In the words of Institutional Group counsel, speaking of this plan in August of 1935, "It constitutes a fair and feasible stand-by arrangement for a period of economic readjustment" (R. 536-7).

The Hearing in June of 1937

The next hearing was not called until June 16, 1937, almost two years later. By this time, of course, the R. F. C. commitment had lapsed by its terms, and the problem of future financing was again in the foreground. A special committee of the Board of Directors (consisting of Messrs. Dick, Colpitts and Davis), reporting in June, 1937, found that the two principal problems foreseen in 1935, namely, future financing and the cumulative interest feature in the Debtor's plan respecting the 5s of 75 (R. 586-8), were still of first importance, but concluded that in view of the basic uncertainties affecting not only the Debtor but also the entire railroad industry, it was impracticable to formulate at that time a sound plan of reorganization (R. 589).

The special committee recommended an extension of at least six months to allow further studies. Indeed, at this time (summer of 1937) Mr. Colpitts, a consulting engineer with a wide and recognized experience in the railroad field, was of the opinion that the expense of an immediate and intensive study would be unwarranted, inasmuch as the results, even before a new plan could be formulated, would become obsolete (R. 591).

The Institutional Group reaffirmed its approval of the Debtor's Plan at this June 1937 hearing, and expressed its willingness to accept an adjournment of six months (R. 630).

The Hearing in September of 1937

The next hearing, postponement of which had been requested by the Debtor and denied (R. 643), was held three months later, on September 20, 1937. Counsel for the Debtor stated that with provision for a financing medium

and limitation of the full accumulation of contingent interest on the 5s of 75 to some definite period of time, the Debtor's Plan would be fair, equ ble and feasible even in the light of circumstances in 1937 (R. 687).

Mr. Walker, Chairman of the Institutional Group, insisted that the changes indicating the inadvisability of adopting the Debtor's Plan as filed did not arise till 1937 (R. 684-5). The following statement of his sums up quite accurately the attitude underlying the preparation and presentation of the Debtor's Plan (R. 689):

> "* * * it is a plan that in the best judgment of those who worked on the plan at that time would give the opportunity *to demonstrate during this so-called stand-by period the earning capacity of this railroad instead of relying at that time upon a permanent and final capital structure* that was based *purely upon forecasts in the depth of the traffic depression*, practically, of 1935."

The Closing and Reopening of the Hearings

At the conclusion of this testimony, taken on a single day (September 20, 1937), the presiding Commissioner closed the hearings, contrary to the views of most of the parties as to the necessity for further hearings (R. 673).

A reopening was requested by the Institutional Group, which transmitted to the Commission a resolution adopted by it containing a commitment to prepare and present within a short time a plan of reorganization, "with evidence in support thereof". The Commission granted the request and set January 10, 1938, as the deadline for submission of a new plan (R. 692).

There was no time for conferences (R. 827-8, 890-1). The Institutional Group hurriedly turned out a plan of its

own (I. C. C. Ex. 174) in the ensuing period of approximately three and a half months and filed it on January 10, 1938, the deadline set by the Commission. On January 19 the Debtor submitted to the Institutional Group a proof of its proposed modifications of the latter's Plan (filed in final form on February 1 as I. C. C. Ex. 189). On the following day they had a two-hour conference (R. 890). On January 24 the Institutional Group filed a modified plan (I. C. C. Ex. 175, herein sometimes called the "Institutional Group's Plan"), but because of the pressure of the existing circumstances the only opportunity for discussion and the only discussion of the subject between representatives of the Group and of the Debtor took place during the two-hour conference on January 20 (R. 890-891).

On February 1 the reopened hearing began. At the outset of the hearing Director Sweet stated that a third purported plan submitted by an independent committee for bondholders had been filed too late for presentation (R. 696-7).

The Hearings in February and March of 1938

The lien changes in the Institutional Group's Plan were obviously drastic. In that plan the 5s of 75 lost their lien and were relegated to the position of receiving new Series B income bonds and stock—whereas, under the Debtor's plan their lien had been left undisturbed. Confronted with this sudden change in conditions, counsel for the Fifty Year Mortgage Trustees requested time to call a meeting of the bondholders in order to apprise them of this latest development and to enable them to determine what steps should be taken (R. 1020-1). Counsel for the Debtor, joining in the motion for postponement of the hearing, pointed out

that the problem of disruption of liens had never been presented to the Debtor or to any security holders until January 10, 1938. He urged that this matter was of such fundamental importance as to make it imperative, in order that a plan with any such feature might be judicially sustained, to adduce further evidence based on adequate studies (R. 1021-1023).

The Fifty Year Mortgage Trustees promptly sent notices to approximately 15,000 holders of the 5s of 75, and a meeting was held on February 28, 1938 (R. 1243). The Protective Committee was formed at that meeting. This Committee is now a respondent herein, but had not received its authorization prior to the final closing of the hearings before the Commission in March 1938.*

The Commission set March 21 for a hearing. The Fifty Year Mortgage Trustees petitioned for a postponement thereof but this petition was denied (R. 1025). At the March 1938 hearing the Fifty Year Mortgage Trustees and Mr. William Church Osborn** both requested that this Protective Committee be given authorization and time to make a proper survey and studies (R. 1154-5). The request was denied. The hearings were closed on March 22 and were not thereafter reopened.

Conclusion of Proceedings before the Commission and the District and Circuit Courts

In their brief before the Commission, filed May 31, 1938, the Fifty Year Mortgage Trustees again pointed out

*This authorization was received only on May 24, 1938. 228 I. C. C. 180.

**An individual holder of 5s of 75 who intervened in this proceeding and presented testimony at the February and March 1938 hearings.

the insufficiency of the evidence and data in the record as a basis for any fair and equitable permanent reallocation of securities predicated on a disturbance of existing liens. They also specified further data which they considered essential to adequate treatment of the 5s of 75, including a proper formula for segregating earnings and severance and contributed traffic studies.

In the fall of 1938 the Commission's Examiner submitted his proposed report (R. 1162 *et seq.*). On December 30, 1938 the Fifty Year Mortgage Trustees filed their exceptions to this proposed report and their supporting brief. The request for adequate evidence and data was reiterated both in their brief and oral argument. When the Commission's report and order of February 12, 1940, embodying its plan of reorganization, were received, the Fifty Year Mortgage Trustees filed a petition for modification, again pointing out the inadequacy of the basic record as a foundation for a major disruption of liens and requesting adequate studies. Later the Commission issued its supplemental report and order of June 4, 1940, which contained no substantial change in its Plan as affecting the 5s of 75. At the subsequent hearing before the District Court, the Fifty Year Mortgage Trustees repeated their objections and requests in brief and in oral argument.

The District Court approved the Plan substantially in the form certified to it by the Commission, and the Fifty Year Mortgage Trustees and the Protective Committee appealed from this order. The Circuit Court has reversed the order of approval of the District Court and remanded the proceedings to the Commission.

SUMMARY OF ARGUMENT

I. The meager data as to segregated earnings are not a proper basis for a permanent disruption of liens.

II. Neither a severance study nor a contributed traffic study has been made.

III. Earnings results not considered by the Commission in making allocations, but which were later put into evidence before the Court by the Debtor's Trustees, demonstrate clearly a greater relative worth for the 5s of 75 than the Commission's Plan recognizes.

IV. In subordinating the 5s of 75 to prior charges of $9,675,000, the Commission disregarded important elements of value upon which these bonds have a lien.

V. Relevant factors other than earnings, which are necessary to a determination of fair allocations, were not considered.

VI. The change from debt to stock in the new capital structure is particularly unfair to the 5s of 75 because of the impact of taxes.

VII. The public interest does not justify the virtual confiscation of the income earned by the security supporting the 5s of 75.

ARGUMENT

I. THE MEAGER DATA AS TO SEGREGATED EARNINGS ARE NOT A PROPER BASIS FOR A PERMANENT DISRUPTION OF LIENS

The method gradually developed and now well recognized in Section 77 reorganizations for judging earning power of the component parts of a system.

When a plan under Section 77 proposes to disrupt liens and to effect drastic changes in the existing rights of security holders, there must, of course, be an adequate foundation of essential facts to support the proposed disruption and the method of allocating new securities. Section 77 contemplates that in such allocation the predominant element to be considered in determining the value of railroad property is earning power. The provisions of Section 77* thus apply to railroads the same principle that this Court has held applicable to other business enterprises in the *Consolidated Rock Products* case.

Out of the many reorganization proceedings under Section 77 there has developed a technique, which has come to be generally recognized and used, for arriving at an earnings value of the various component parts or mortgage divisions of a railroad system. This recognition and use, however, have developed gradually. While the technique was occasionally applied to reorganizations under the old equity practice, its use on a general scale has come about only in reorganizations under Section 77. The less frequent use of such technique in the years immediately following the

*See particularly the amendments of Section 77 in 1935—*e.g.*, subsection (e), last paragraph.

enactment of Section 77 was doubtless due in large part to the "stand-by" character of many of the plans proposed thereunder in that early period.

The technique so developed includes three kinds of formulae or studies,* namely:

(1) earnings segregation studies,

(2) severance studies,

(3) contributed traffic studies.

Of the three studies the greatest weight is given to earnings segregation studies, which represent the separation of revenues and expenses of a system among its component parts or mortgage divisions on the basis of system operations as actually conducted. Such a study is designed to show the earning power of these various divisions and thus their relative share in the earnings of system operations.

In most railroad reorganization proceedings where the mortgage structure has been divisional rather than "blanket", and particularly in the more recently instituted proceedings, the record has included such a study. Thus, in the following railroad reorganization proceedings under Section 77, formulae or studies segregating earnings by mortgage divisions have been developed, applied to system operations, and included in the record, and have formed an important factor in allocating securities:

New York, New Haven and Hartford Railroad Co., Finance Docket No. 10992; 224 I. C. C. 723 (1938)

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*For a general discussion of the nature of these studies, see Meck and Masten, Railroad Leases and Reorganization, 49 Yale L. J., p. 640-7 (1940).

The Denver and Rio Grande Western Railroad Co., Finance Docket No. 11002

New York, Susquehanna & Western Railroad Co., Finance Docket No. 11681

The Chicago, Rock Island and Pacific Railway Co., Finance Docket No. 10028

Erie Railroad Company, Finance Docket No. 11915

Chicago & North Western Railway Co., Finance Docket No. 10881

St. Louis-San Francisco Railway Company, Finance Docket No. 10008

The Commission approved the segregation formula in the New Haven and Susquehanna reorganizations. In the New Haven proceeding the formula was approved by the Court as well.* In the Rock Island proceeding also, the Court approved the segregation formula.

In the Central of Georgia Railway Company reorganization proceeding, I. C. C. Finance Docket 12950, the Commission has recently approved a segregation formula, but no plan has yet been approved therein. While this road went into equity receivership in 1932, its proceedings were transferred to a trusteeship under Section 77 only in 1940.

Of the foregoing roads, only two, the Rock Island and the St. Louis-San Francisco, began their proceedings under Section 77 prior to 1935.

In the pending equity receivership proceeding for the reorganization of Seaboard Air Line Railway Company in the United States District Court for the Eastern District of Virginia a segregation formula has been developed and the question of the manner of allocating new securities under the plan is now before the Special Master.

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*Printed District Court Record, order of May 25, 1938.

The general method for preparing an earnings segregation study (severance studies and contributed traffic studies are discussed in II below) is to devise a formula to be applied to the system generally for separating revenues and expenses by component parts or mortgage divisions. This naturally presents many questions as to the manner in which revenues and expenses shall be separated. Certain revenues and expenses allocable to a division are local and are usually easily ascertainable; for example, the bulk of maintenance of road expenses are directly assignable, since they are for the most part local. In addition, revenues from traffic that moves only on the mortgage division or the transportation expenses incurred in the handling of this local traffic do not present a difficult problem.

The greatest difficulty, however, arises in reaching a fair allocation of revenues and expenses that are "joint" with one or more segments or mortgage divisions. The initial step in the procedure of separating freight revenues on traffic that moves over more than one division is first to ascertain the actual revenues involved, and this is usually done by an analysis of the waybills. This revenue could be divided on a straight mileage pro-rate basis if the divisions over which the traffic moves performed the same operation. However, it is recognized that those divisions originating or terminating traffic incur expenses in addition to road haul expenses and, therefore, should receive a special allocation of revenues in order to compensate for the terminal cost of such origination and termination. A distinction should also be made in the formula between the cost of originating freight traffic and the cost of receiving it in interchange from a connecting line. The additional cost incurred in interchanging traffic is less than the cost of

origination and termination and therefore the special allowance of revenues for this service is usually smaller. The allowances for origination, termination and interchange should be worked out for each road according to the particular circumstances involved. These special allowances are quite often substantial, being expressed either as a percentage of the revenue or as a "mileage block" allowance. In the New York, New Haven and Hartford reorganization proceeding, referred to above, the mileage block which was allowed for origination and termination was the equivalent of 109 miles of road haul in the case of car-load traffic and 71 miles for less-than-carload traffic. That formula* was referred by the District Court to the Interstate Commerce Commission and was approved by the latter before it approved a plan of reorganization for that road. 224 I. C. C. 723.

The methods used in spreading "joint" expenses depend entirely upon the type or kind of expense. Some are spread on a net ton mile basis, while for others a train mile basis is used, and for still others a car-mile or car-day basis.

There are no adequate data as to segregated earnings.

It is important to have a clear understanding of precisely what was available on the important subject of earnings in this case, and when it was available. In considering this matter, we emphasize once more three important facts which go far toward explaining the peculiar

*The application of that formula in an accounting with a formerly leased division was approved by the Circuit Court of Appeals for the Second Circuit, *Palmer* v. *Palmer*, 104 F. (2d) 161 (1939). This Court denied certiorari. 308 U. S. 590.

paucity of data in this record: (a) that the Debtor's plan was proposed in 1935, (b) that it was a "stand-by" plan, and (c) that the Commission felt impelled by the provision of Section 77 contemplating the prompt filing of plans, to close the hearings first in the fall of 1937, to reopen them only upon the commitment of the Institutional Group to file a plan by early January of 1938, and finally to close the hearings in March of 1938—so that the record before the Commission was closed over four and one-half years ago.

At the hearings in 1935 on the Debtor's "stand-by" plan, the evidence was largely formal, as was natural in the case of a plan that did not propose a disruption of major liens. This evidence consisted largely of formal documents, such as organization papers, copies of mortgages, note agreements, statements, maps, annual reports and the like.

Two statements (Exs. 92 and 93) were included, however, purporting to segregate the earnings of the property subject to the 5s of 75 for the years 1930 and 1931, respectively. There were also furnished statements of estimated net income or earnings for the three following mortgage divisions as well: the Milwaukee & Northern (Ex. 81), the Terre Haute (Exs. 89 and 90), and the Chicago, Milwaukee & Gary (Ex. 85). These statements, however, were diverse in kind and lacked uniformity as to the period covered. Thus Exhibit 81, entitled "Estimated Net Income" for the Milwaukee & Northern division, was for the year ending September 30, 1933 and the calendar year 1934. Exhibit 85 for the Gary, on the other hand, had the heading "Gary's contribution to System operated as a part thereof", and covered the years 1928, 1929, 1933 and 1934. The two exhibits for the Terre Haute, entitled "Revenues, Ex-

penses and Net Income", covered the years 1925, 1926, 1933 and 1934.

Exhibits 92 and 93 purporting to show the segregated earnings of the 5s of 75 in 1930 and 1931, were admittedly estimates (R. 343). Mr. Sparrow, the witness introducing the exhibits, stated that the Debtor "could not, in the limited time available, make as thorough an analysis as was made" in the equity reorganization in the '20s (R. 338). He explained that the method followed in obtaining the estimated freight revenues for the Lines West was taken from annual reports to various States showing revenues and expenses of the lines within each State and separating the revenues between intrastate and interstate traffic. The revenues obtained from the interstate traffic were derived by applying a system average revenue ton mile rate to the revenue net ton miles within the State. In connection with using the system average ton mile rate Mr. Sparrow said:

> "The System ton mile revenue will vary from the actual ton mile revenue of any particular state for the reason that in some states the commodities transported carry a lower rate than in others and the average length of haul is not the same, both of which, of course, affect the revenue per net ton mile." (R. 338)

A check of the results was made for two months in the year 1931 by an actual ascertainment from waybills. The revenues obtained from this two-month check were then compared with the estimated revenues contained in the State reports and the margin of error noted. The full year's results were then changed in accordance with this ratio. In other words, an annual ratio was estimated on the basis of an analysis of waybills for only two months in

each year, and this estimated ratio was applied to interstate freight revenues, which in turn were based on the assumption that it was proper to apply to the revenue net ton miles of the 5s of 75 the system average revenue per revenue net ton mile.

The only other exhibit purporting to reflect segregated earnings for the Lines West which was introduced prior to the final closing of the hearings before the Commission* was No. 145, introduced at the hearing in June, 1937. This exhibit was for the year 1936** and was prepared on substantially the same basis as Exhibits 92 and 93 just described, except that it was based on an actual ascertainment from waybills for four months out of the year instead of only two (Ex. No. 146). In other words, this exhibit for the year 1936 also reflected the result of estimates applied to estimates.

Counsel for the Debtor, reflecting the views of Mr. Sparrow, who was responsible for the exhibits purporting to segregate earnings, stated the latter's views thereon as follows (R. 1022):

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*After the Commission had approved the Plan, however, there was introduced at the hearings before the Court in September 1940, Exhibit 34, which purported to reflect the segregated earnings of the Lines West for the 3½ year period, July 1, 1935-December 31, 1938, and which showed a substantial deficit for them therein. This exhibit used for the year 1936 the results shown for that year in I. C. C. Exhibit 145, described above; for the other years interstate freight revenues represented an actual ascertainment from waybills for every month. In other respects, however, this exhibit was prepared on the same basis as Exhibit 145.

**At the hearing in June 1937 independent exhibits were also introduced for the Terre Haute (Ex. 139), Milwaukee & Northern (Ex. 141) and Gary (Ex. 143)—all for the year 1936.

> "Now, it is not already in the record, but I would be glad to be sworn, if my statement to this effect cannot be admitted, but it is a fact that Mr. Sparrow, *the man who is responsible for the only kind of a segregation study that was made,* even he has stated to the board, and advised the Board of Directors himself, that *in his opinion that study was inadequate to determine the propriety of the proposal for the disturbance of the lien.*"

Again, one paragraph later, Debtor's counsel said (R. 1022):

> "Had Mr. Colpitts been able to stay over until this morning, or had he been permitted to testify last night, he would have said that in his opinion *there are no facts before the Board of Directors today* upon which an expert in these problems can frame a conclusion as to *whether it is proper to disturb the lien of the Fifty-year Five's as this plan proposes.*"

Director Davis testified to the same effect (R. 951-2).

The Debtor and its experts were not alone in this view. Mr. Parker, a consulting accountant with a long and varied experience in railroad matters and the expert for intervenor William Church Osborn, was definitely of the opinion that the information that had been gathered prior to the final close of the hearings in March 1938 could not serve as a proper basis for segregation and allocation (R. 1104-5).

The Institutional Group also was thoroughly aware of the restricted nature and extent of the Debtor's studies and of the limited purpose for which they were prepared. The Chairman of the Group, while admitting that he had made no investigation of the methods back of the "formulae" (R.

877), believed that officers of the Debtor had given sufficient consideration thereto to warrant the characterization thereof as "studies". Reasons for this belief for which, it is submitted, there is no support in the record, were not expressed. On cross-examination Mr. Walker stated (R. 878):

> "My own feeling in connection with this situation is that the studies that have been made *to the extent that they are to be dignified with the name of 'studies'* by the organization of the Debtor, that their own knowledge of the conditions of the property are sufficient to determine the relative value of these mortgages."

This the Debtor emphatically denied. In fact it had not even attempted to decide this question. In the words of its counsel, with particular reference to the proposed destruction of the lien of the 5s of 75 (R. 1022):

> "What we are saying is that *we are agnostic,* we don't know, and *there is no record* upon which the Bureau of Finance or the Interstate Commerce Commission or anybody else can found an opinion on that question."

For a plan of the type and having the purpose of the Debtor's Plan the usual comprehensive studies were of course not strictly necessary, and the probability of their speedy obsolescence and inapplicability raised doubts as to the wisdom of incurring the expense of an intensive investigation during years such as 1935 and 1936. As a result no thorough studies were made. A mere reading of the record confirms the clear statements to this effect by those who were chiefly instrumental in its compilation.

Specific Criticisms of the So-Called "Formula" for the Lines West.

In the first place, there was "no general determination of a formula" here (R. 829). Instead, four "independent" exhibits were introduced. Furthermore, not even a separate study or statement was made of the earnings of the General Mortgage Bonds (herein sometimes called the "Generals"), but they were allocated all the system earnings remaining after deducting the earnings shown for the four mentioned above (R. 829).

Thus there was not applied to the Generals the same method that was applied to the 5s of 75. Moreover, since an independent study was not made for the Generals, there was no way of checking whether the above statements reached a substantial degree of accuracy, as would have been possible by adding the results for the four divisions and the Generals.

In the second place, the only studies that were before the Commission when it certified its plan of reorganization were, as seen above, largely on an estimated, instead of an actual, basis.

In the third place, there was no allocation to compensate divisions for the important cost of origination and termination of traffic.

Apart from the nature of the "formula" itself, its application was equally defective and restricted. Apparently because the year 1936 was the only calendar year which (even on the above estimated basis) was covered by the separate and "independent" studies for the four mortgage divisions, the Commission proceeded to use that year as the principal test year for its Plan (R. 2252 *et seq.*). While

that was a year of some improvement in general business, agricultural conditions were most unfavorable on the Lines West, particularly from the Missouri River to the Rocky Mountains. Crop production generally speaking was only a fraction of normal in this territory, as the following figures demonstrate (Source: *Agricultural Statistics*, 1937, published by the United States Department of Agriculture):

CROP PRODUCTION
(In 000's of Bushels)

	South Dakota		Montana	
	Average 1928-32	1936*	Average 1928-32	1936*
Wheat	37,003	4,286	45,160	13,626
Corn	78,447	8,446	1,401	540
Oats	59,033	12,712	7,214	2,244
Barley	35,277	8,977	3,826	798
Rye	4,072	1,608	574	90
Flaxseed	2,170	132	1,149	32
Potatoes	3,971	783	2,042	1,520
Hay**	1,126	582	1,992	1,302

*Preliminary figures.
**Short tons

The above discussion of revenues relates to freight revenues. Coming now to passenger and other revenues: As shown by Exhibit 146, "some years ago" an allocation of passenger revenues was made to the Lines West. It was assumed that these figures less 1% would fairly represent the passenger revenues of these lines in 1936. Just why these old allocations were used does not appear. Presum-

ably the reason was that these figures were handy, and at the time when liens were to be left undisturbed, there was no cogent reason for making a proper study.

Similarly an allocation of mail revenues was made "some years ago", so these figures less 5% were likewise taken as a satisfactory indication of test revenues (I. C. C. Ex. 146).

These revenues are by no means unimportant; they amount to approximately 10% of total System gross operating revenues, as the Annual Reports of the Debtor show. Nevertheless the record does not even give the year for which the test revenue compilation was made, nor does it provide evidence that the percentage adjustments are anything but arbitrary.

II. NEITHER A SEVERANCE STUDY NOR A CONTRIBUTED TRAFFIC STUDY HAS BEEN MADE.

Nature and Purpose of Study

The two studies often made in the development of a plan of reorganization, other than earnings segregation studies, are, as stated above, a severance study and a contributed traffic study. These studies are supplemental to segregation studies and are based upon them. It often happens that the results of the segregation study may show a particular mortgage division as having relatively poor earnings value, or for that matter a deficit, on the basis of system operations as actually conducted. On the other hand, a severance study or a contributed traffic study may show the particular division as having an added or lessened value, in that, for example, it either saves money to the

system (as in the case of a cut-off line) or it is a very large originator of profitable traffic for the system.

A severance study is an analysis of the probable effect of the hypothetical separation of a particular segment or division from the rest of the system.

A contributed traffic study, the basic data for which are usually included in a severance study, shows the revenue contributed by a particular segment and by the balance of the system on traffic moving to and from that segment. Such a study usually also shows the out-of-pocket expenses for handling such traffic and enables an approximation to be made of the effects of the net loss of this traffic to the system.

We have always urged that adequate severance studies be made. None have ever been made in this proceeding. The Debtor declared that it was unable to supply them in connection with its plan (R. 574). When the Institutional Group submitted its plan it failed to provide for such severance studies, apparently because it thought that this would be "difficult" (R. 874). When the Commission formulated its plan, it caused no such studies to be made, and its treatment of the 5s of 75 was made in reliance upon the inadequate data as to segregated earnings described above. Thus the allocations in the Commission's Plan were made without the benefit of a severance study or contributed traffic study.

Such studies have been made and taken into consideration in the development of plans of reorganization in the following proceedings: the New Haven, the Erie, the Chicago & North Western, and the Florida East Coast Railway Company.* A severance study and contributed traffic

*The I. C. C. finance dockets of these reorganization proceedings are given above, except that of the Florida East Coast Railway Company, which is Finance Docket No. 13170.

study have also been developed in the pending equity reorganization proceeding of the Seaboard Air Line, referred to above.

Exhibit 34 (referred to above) at the Court hearing in September 1940 purporting to show the segregated earnings for the Lines West for the three and one-half year period, July 1, 1935-December 31, 1938, had a footnote showing the gross revenues of traffic interchanged between the Lines East and the Lines West and dividing these revenues in the proportion contributed by the Lines East and the Lines West. The figures in this footnote, since they represent only gross freight revenues, do not take into consideration the expenses incident to handling the traffic which are necessary in order to arrive at a net income figure.

While these figures can by no means be dignified by the name of a contributed traffic study without a proper disclosure of the details of their compilation (and perhaps not even then, depending on what such details would indicate), they do indicate that the 3½-year total of railway operating revenues for the period through 1938 derived for the Debtor from traffic interchanged between the Lines West and the Lines East was over $56,000,000, and that of this the General Mortgage lines and the other lines of the Lines East contributed less than $16,000,000, while the Lines West contributed over $40,000,000.

This shows, at the very least, that severance and contributed traffic studies might be of great importance in this case, and that the 5s of 75 have been warranted in insisting that such studies should be available for use as one of the factors to be taken into account in the allocation of new securities. Certainly mere "difficulty" should not prevent

their being made when a proposal is advanced that destroys a major lien permanently and almost in its entirety.

No additional data were put into the record in connection with the Commission's plan.

We have dealt at some length with the background of the proceeding before the Commission and with the respective natures and aims of the Debtor's and Institutional Group's plans, because the analysis applies equally to the Commission's Plan. The Commission, having denied the request of the Fifty Year Mortgage Trustees and others for time for the development of additional studies and having closed the hearings, could rely only on the same sketchy material that the Debtor and the Institutional Group used.

Without attempting to remedy the situation the Commission certified its Plan to the District Court. Its Report contained, of course, the usual form of language to the effect that full consideration and due weight had been given to all the relevant factors, but specific answers to the criticisms advanced were not even attempted. The District Court took the view that the Commission must have given matters careful consideration on the whole, and that it was well qualified to do so. While the Circuit Court, as shown above, included in its opinion the general observation that the evidence in the record "permits" of a plan such as the Commission approved, it clearly pointed out that the parties have the right to review "both the sufficiency of the findings to support the plan and *the existence of evidence to support the findings*".

For the ability of the Commission and its staff we have the utmost respect. Their knowledge of railroads as transportation units is exceptional. But when a record lacks the usual studies requisite to making a proper allocation, even the Commission cannot reach a sound conclusion. If it be contended, as the briefs of the Groups and the R. F. C. imply, that the Commission's special knowledge, acquired through years of experience, has enabled it to reach a determination without the preparation of a full record, the answer is that the Commission's special knowledge relates to railroads generally or to the properties and operations of one railroad taken as a whole. Except in reorganization proceedings, there is no necessity or occasion for the Commission to know, or have any basis for knowing, the relative earnings and values of separate portions of a road (artificially divided into mortgage districts), which is the only basis on which the distribution of new securities can properly be made.

III. EARNINGS RESULTS NOT CONSIDERED BY THE COMMISSION IN MAKING ALLOCATIONS, BUT WHICH WERE LATER PUT INTO EVIDENCE BEFORE THE COURT BY THE DEBTOR'S TRUSTEES, DEMONSTRATE CLEARLY A GREATER RELATIVE WORTH FOR THE 5s OF 75 THAN THE COMMISSION'S PLAN RECOGNIZES.

At the hearing in the District Court on April 14 of this year on the petition of the Trustees of the Debtor's estate to pay interest on certain bonds, including the 5s of 75, the Trustees introduced an exhibit (No. 1) purporting to show the segregated earnings of the four mortgage divi-

sions for the 3-year period, January 1, 1939 to December 31, 1941. This exhibit was prepared on the same basis as those previously introduced before the Commission, except that (as in the case of the years subsequent to 1936 shown in Court Exhibit 34) it was based on actual ascertainment from waybills for every month.

This exhibit showed net income for the latest available 3-year period of $13,264,705 for the 5s of 75 as against $16,859,867 for the General Mortgage Bonds. Pursuant to the hearing on April 14 of this year, the Court authorized the payment of approximately $19,000,000 as interest on bonds of the Debtor, of which, however, over $16,000,000 was paid as interest on the outstanding General Mortgage Bonds, but only $2,577,000 was paid as interest on the 5s of 75.* The amounts represent the accruals of interest during these three years on the new securities which would be received by the General Mortgage Bonds and by the 5s of 75 under the Commission's Plan. The great disparity between treatment under the Commission's Plan and earnings value is shown by the fact that, whereas the General Mortgage Bonds received interest payments equal to practically 100% of their earnings during the period 1938-41 ($16,104,000 out of $16,859,867), the 5s of 75 received less than 20% of their earnings during the same period ($2,577,000 out of $13,264,705).

It is difficult to see why the basis for allocating new securities, other than fixed interest bonds, should not take into account good years as well as bad. Great weight, of course, must be given to the earnings in poor years in

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*Printed District Court record, pages 9709-18.

setting the amount of total new fixed charges. This the Commission has done. There is no valid reason, however, for using as the basis of allocating junior securities in the new capitalization to existing security holders, only years which are unfavorable to them—as the year 1936 has been shown to be to the 5s of 75.

The Commission, using 1936 as the chief test year, proceeded on the assumption that the Lines West are deficit lines (R. 2252, 1307). So did the District Court (R. 1889) and the Circuit Court. The Circuit Court, in reaching its conclusions, was under the serious misapprehension that the Lines West had had an annual deficit of over $5,000,000 (R. 2311, footnote). Apparently the Circuit Court misread line 32 of Court Exhibit 34. Even assuming the formula to be correct for argument's sake, the figure of $5,093,854 there listed is for the 3½-year period July 1, 1935 to December 31, 1938, and the annual deficit would be approximately no more than $1,500,000 in such period. Furthermore, even this figure is beside the mark, because it does not show the net income from the other security supporting the 5s of 75, which, as shown under Part IV below, converted any deficit of the Lines West, even in poorer years, into a net income. In addition, there was such a large net income for the subsequent years that results based upon Exhibits 1 and 34 above show a net income for the 5s of 75 for the 6½-year period ending December 31, 1941 (including the above 3½ years) of over $11,700,000.

IV. IN SUBORDINATING THE 5s of 75 TO PRIOR CHARGES OF $9,675,000, THE COMMISSION DISREGARDED IMPORTANT ELEMENTS OF VALUE UPON WHICH THESE BONDS HAVE A LIEN.

In its Report the Commission (R. 2251, *et seq.*) commented on the Debtor's "studies" for 1930, 1931 and 1936, which purported to show a substantial net system income but a deficit from the operation of the Lines West. This deficit was largely a guess since the types of studies usually made were not made here. In addition, this deficit would not only be dissipated in the year 1936—the only year for which a detail of the figures was contained in the report—but it would be converted into a net profit if the earnings from the Pieces East, from the Indiana Harbor Belt stock and from the Terre Haute lease, upon all of which the 5s of 75 have a lien, are included. The Debtor's testimony respecting the operations for 1936 (R. 2252) purported to show that the system income was $12,298,916 while the deficit for the Lines West was $1,108,535. These same "studies" showed, however, that the income from the Pieces East for this year was $170,100, from the Indiana Harbor Belt stock $402,031 and from the Terre Haute lease, on an out-of-pocket basis, $875,327; or a total of $1,447,458 (something over $300,000 more than the alleged deficit). In addition, the average net income from the Terre Haute lease alone on a tariff basis was shown to be approximately $2,195,431.80 a year above all interest charges for the years 1925, 1926, 1933, 1934 and 1936 (R. 2212). Even in the year 1936 this excess was $1,966,546 (R. 2213).

The Commission rationalized the subordination of the 5s of 75 to charges of $9,675,000 in a curious manner. It

stated that the inclusion of the income from the Pieces East and from the Terre Haute was "questionable" (R. 2254) and then, in commenting on the testimony of the witness who testified on behalf of the 5s of 75, purporting to show larger earnings for the Lines West, the Commission stated that this witness "did not attempt a new analysis of each mortgage division consistent with his revision of the Debtor's study for the western lines. We think that if the earnings studies for 1936 are to be rejected, there is no satisfactory substitute short of a new segregation study embracing the entire system." With this latter comment we fully agree. Indeed, it is our position that the record contains no satisfactory substitute for a segregation study embracing the entire system.

The Commission brushed aside the question of income from the Pieces East and from the Terre Haute (despite the fact that the General Mortgage has never presented for adjudication the belated claim that the Pieces East are subject to its after-acquired property clause, and that provision is made in the Plan for keeping the Terre Haute in the system), and seemingly disregarded the Indiana Harbor Belt stock (despite the fact that it states in its own report (R. 2247) that the evidence in the record indicates "a high value"* for this stock).

The Commission then referred to the Examiner's Report (R. 2254). This report recommended the participation by the 5s of 75 when the system income available for interest exceeds $6,364,602, after payment of $2,500,000 to

*This stock has paid dividends of approximately $300,000 a year. Mr. Barriger, witness for R. F. C., testified that it was not beyond the range of possibility that it alone could be sold for enough to cover all the First and Refunding Bonds (R. 963-6).

the Additions and Betterments Fund. As to this report the Commission stated simply: "We do not consider such treatment of the Fifty-Year Bonds to be justified on any basis of earnings shown"; apparently basing this principally on the testimony above commented on respecting the 1936 earnings. It then proceeded to make its allotment of securities to the 5s of 75, saying: "If the holders of the Fifty-Year Bonds are assigned a part of the new Series B Income Bonds only, as herein provided, they will begin to share earnings with the General Mortgage Bonds and Northern Consolidated Bonds after $9,675,000 of prior charges * * *."

Thus, the Commission first increased the amount which the system will have to earn in the future before the 5s of 75 begin to share therein, from the $6,364,000 recommended by the Examiner to $9,675,000. But when the system income available for interest exceeds this latter amount, and when the 5s of 75 will be on the point of beginning to participate therein (in the proportion of less than 40% of such excess), the discretionary betterment fund of an additional $2,500,000* may then come in to postpone their right to share until the amount available in any one year exceeds $12,175,000. Even after the amount available for interest and the above charges exceeds $12,175,000 in any one year, the 5s of 75 would, as holders of new bonds (of Series B), participate in the excess only up to 15% of the amount now due on the 5s of 75. This treatment, the Commission concludes

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*The use of this additional discretionary betterment fund would result, in effect, in the 5s of 75 furnishing in such a year, a substantial part of the additional maintenance for the benefit of the whole property.

"goes far toward resolving the doubts as to the accuracy or fairness of the allocation of earnings in favor of the Fifty Year Bonds, without injustice to the General Mortgage Bonds" (R. 2254-5).

We submit that the above observations of the Commission respecting the treatment accorded the 5s of 75, are not a statement of "reasons" sufficient to comply with the provisions of Section 77 (d), which requires the Commission, in its report, to "state fully the reasons for its conclusions".

We respectfully represent that the earnings available to the 5s of 75 from the properties upon which they have a superior lien and the additional value of the 5s of 75 as shown by the record, admit of no such subordination as is provided in the Commission's plan.

V. RELEVANT FACTORS OTHER THAN EARNINGS WHICH ARE NECESSARY TO A DETERMINATION OF FAIR ALLOCATIONS, WERE NOT CONSIDERED.

Even assuming for the sake of argument that the earnings of the Lines West are not seriously understated, the fact remains that Section 77 does not contemplate the use of earnings as the sole factor in determining the allocations of new securities under a plan of reorganization. Subsection (e), relating to the value of railroad property, provides:

> "* * * The value of any property used in railroad operation shall be determined on a basis which will give due consideration to *the earning power* of the property, past, present, and prospective, *and all other relevant facts*. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of

the property, and the actual investment therein, as may be required under the law of the land, in light of its *earning power and all other relevant facts.*"

Indeed, in discussing in its Report the allocation to the Terre Haute Bonds as compared with the allocation to the General Mortgage Bonds the Commission specifically takes relative mileage and asset value into account (R. 2215-6), yet it is obvious from an examination of the Report that the Commission completely disregarded these same factors in considering the allocation to the 5s of 75.

Asset and Mileage Coverage

The following table shows the mileage and valuation relationships of the properties underlying the 5s of 75 to those of the System:

	Lines Subject to Fifty Year Mortgage*	Lines of System**	Percentage of System
(1) Miles of the first main track (wholly owned)	3,393	10,031	33.9%
(2) Original cost except land	$217,052,949	$694,263,606	31.3%
(3) Cost of reproduction new	252,468,812	818,280,465	30.9%
(4) Cost of reproduction less depreciation	190,054,042	546,341,054	34.7%
(5) Value of lands and rights	7,929,980	78,259,228	10.1%
(6) Working capital	—	7,727,300	—
Sum and System relationship of (4), (5) and (6)	$197,984,022	$632,327,582	31.3%

Source: For valuation figures, I. C. C. Bureau of Valuation Report on Elements of Value as of December 31, 1935.

*Excluding the Lines East on which the General Mortgage has a first lien.

**Excludes the Terre Haute.

The foregoing table illustrates two things. First, it shows that there is a wide margin of asset coverage for the mortgage district of the 5s of 75, of which the principal amount outstanding is $106,395,096. Second, it shows that this mortgage district is secured directly by a lien on approximately one-third of the Debtor's total first main track and asset value.

VI. THE CHANGE FROM DEBT TO STOCK IN THE NEW CAPITAL STRUCTURE IS PARTICULARLY UNFAIR TO THE 5s OF 75 BECAUSE OF THE IMPACT OF TAXES.

No statement regarding the unfairness of the allocation to the 5s of 75 would be complete without a reference to the huge tax burden, placed squarely and entirely on the new stock, and therefore imposed primarily on the 5s of 75 by virtue of the fact that 85% of their claim is changed from debt to stock.

When the Commission formulated the proposed plan, one vital factor which now exists was not before it, namely, that if debt securities are changed into equity securities the value of the latter is greatly impaired by resultant income and excess profit taxes upon the Debtor. The reason for this impairment is that under the Commission's Plan, by reason of the allocation of equity securities for 85% of the claim of the 5s of 75, as well as for portions, or all, of the claims of other mortgage issues of the Debtor, fixed or contingent interest charges of something over $14,000,000 a year are eliminated. These interest payments were deductible by the Debtor in determining its taxable net income whereas any dividends on the new preferred or common

stock are not so deductible. This additional income is under present tax laws (after deduction therefrom of any excess profits taxes thereon) subject to income and surtax charges of 45% under the present Senate bill. If this income is subject to excess profits taxes (which depends upon the amount of the income in any year and upon the amount of invested capital exemption of the Debtor in that year), there will be a tax thereon of either 80% or 90% thereof, depending upon whether the Senate or the House version of corporate tax legislation now being considered is adopted.

The Commission in its report referred to testimony by the Debtor estimating that the income taxes to be borne by it would in 1939 be only approximately $225,113, in 1940 $1,103,681 and in 1941 $2,040,997 (R. 2181). The event has proven otherwise.* As shown below, because of taxes on the reorganized company resulting from the conversion of present debt into stock, substantial dividends upon the new preferred stock could be paid only in years of very large income, and there appears little hope for the payment of any dividends upon the new common stock, except in years of extraordinary income. In other words, not only is the lien of the 5s of 75 destroyed, but even the possibility of income thereon is likewise greatly impaired.

We wish to make it perfectly clear that we are not complaining about taxes as such, and that we fully appre-

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*The Commission stated that payments of dividends should be "a reasonable prospect, at least on the preferred stock", and estimated that if earnings approached those of the normal year (apparently assumed by the Commission to be about $15,000,000) dividends could be paid (R. 2221). This is now all changed—out of such earnings no dividends could be paid.

ciate the higher government revenues needed for the war. But the point involved is entirely different: the effect of the Commission's Plan is to saddle upon certain ranks of the Debtor's bondholders a tax burden that is practically confiscatory and that should be shared by the other members of the American public.

The salutary effect of an excess profits tax and a higher income tax on industries receiving increased business and abnormal profits by reason of war demands is one thing; but the impact of such taxes on a situation which is the result of changes in the form of securities which are dictated primarily in the public interest, is another. The Commission, in the public interest, desires to prevent railway insolvencies in the future. This it should do. To this end, if the other factors were the same in both cases, the conversion of substantial amounts of fixed interest debt into stock rather than into income bonds would not necessarily be unsound. Either one guards effectively against future bankruptcy.

What happens here, however, is that this new stock is subjected to a tax that it was never intended to bear. Though the Debtor is insolvent, its proposed successor, by the device of saying that the bulk of the debt is stock, is placed in a position where it is made to show net earnings that appear on the surface to represent an enormous profit, the major part of which is illusory.

These earnings represent a return that, in a considerable amount is at the present time interest on bonded debt. The money was legitimately invested, and of benefit to both the Debtor and the using public. It is in the public interest to provide a capital structure that will not succumb readily to

another bankruptcy; but it is certainly not in the public interest to create a capital structure that in practical effect confiscates the bulk of these earnings—especially when this is entirely unnecessary to the formulation of a sound plan. Quite aside from public interest, such an arrangement violates the essentials of equity and fairness.

As shown by the annual report of the Debtor for the year 1941, it had earnings for that year available for payment of fixed charges of approximately $28,900,000. This sum is more than twice the fixed charges (including interest on the 5s of 75) under the Debtor's old capitalization. It is probable that out of these extraordinary earnings full dividends could not be paid on the new preferred stock, and it is certain that nothing could be paid on the new common stock.* In years of smaller gross and net incomes (and most years will be so) the holders of the new preferred stock could hardly hope to receive any dividends. This constitutes a deprivation of the property rights of these bonds.

The Circuit Court unqualifiedly stated (R. 2314) that "Every dollar of value of Debtor should be allotted to its creditors", but it made no effort to consider the tax problem at all in relation to a fair capital structure, nor did it comment on the obvious violation of the aforesaid principle

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*It is estimated that even if, under legislation now before the Senate, the Debtor can carry over the depreciated cost of its properties as an invested capital exemption, it would have insufficient funds remaining from its net income for 1941, after the deduction of all charges including the full amount of the betterment fund, to cover the whole of the dividend on its new preferred stock, and that it would have nothing from which dividends could be paid on its new common stock.

resulting from the Commission's wholesale conversion of fixed-interest debt into stock rather than into income bonds. We respectfully urge this Court to rule on this point.

It may be said that no one can tell whether the present taxes on corporations will remain. This is true, but it would be unrealistic to assume that the system of corporate taxes as they now exist will be totally, or even materially, eliminated in the reasonable future.

VII. THE PUBLIC INTEREST DOES NOT JUSTIFY THE VIRTUAL CONFISCATION OF THE INCOME EARNED BY THE SECURITY SUPPORTING THE 5s OF 75.

The matter of public interest is separate and distinct from the question as to whether the treatment of the various classes of security holders is fair and equitable, although the two have been considered together in the briefs of the Groups and the R. F. C. in their efforts to justify what is in effect confiscation of the rights of many of the security holders in the Commission's Plan.

We do not deny that the public interest is paramount. What must be done in the public interest must be done, and the law provides a ready and effective method of accomplishing such a result. This method is well known, and is clearly pointed out in the opinion of this Court in *Louisville Joint Stock Land Bank v. Radford,* 295 U. S. 555, 602 (1935):

> "For the Fifth Amendment commands that, however great the Nation's need, private property shall

> not be thus taken even for a wholly public use without just compensation. If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public."

A fortiori this applies when the public, and not the mortgagor, is to benefit.

Since it is admittedly in the public interest to avoid frequent foreclosures, the Commission's views as to what the Debtor can earn in bad years are entitled to great weight. However, the allocation of securities as between different classes of existing security holders is a matter of private interest; and the allocation of new securities to mortgage bondholders, with a greatly impaired possibility of income because of the nature of these new securities, cannot be justified by general references to public interest. Indeed, it is in the public interest that an investor, when he make a legitimate loan to a solvent road, may do so with confidence that his rights will not be needlessly sacrified in the event of insolvency, even though the specific remedy he was promised is denied him.

CONCLUSION

This Court should affirm the order of the Circuit Court reversing the order of the District Court, and should direct that these proceedings be sent back to the Commission

with instructions to it to have an adequate record made and to formulate a fair and equitable plan of reorganization based thereon.

Respectfully submitted,

EDWIN S. S. SUNDERLAND
MALCOLM FOOSHEE
15 Broad Street
New York, New York
Attorneys for Fifty Year Mortgage Trustees

HENRY F. TENNEY
Of Counsel

C. FRANK REAVIS
20 Pine Street
New York, New York
Attorney for Protective Committee for Fifty Year Mortgage Bonds

MALCOLM MECARTNEY,
Of Counsel.

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